

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 263.00-00
CASE-MIS No.: TAM-108603-07

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Subsidiary =
A
Consultant =
Business A =

Business B =
Market A =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =

Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =

ISSUE:

Whether costs incurred by the taxpayer in investigating and pursuing potential business restructurings that were not consummated by the taxpayer are deductible as ordinary and necessary business expenses under § 162(a), are deductible pursuant to the provisions of § 165, or are nondeductible capital expenditures pursuant to § 263(a).

CONCLUSION:

Costs incurred by the taxpayer in investigating and pursuing non-mutually exclusive, potential business restructurings that were not consummated by the taxpayer are deductible pursuant to § 165 at the time the taxpayer abandoned each potential option. Costs incurred by the taxpayer in investigating and pursuing mutually exclusive transactions must be capitalized as part of the costs of the completed restructuring transactions.

FACTS:

The taxpayer is primarily engaged in the business of Business A to consumers and small businesses. Prior to Year 3, the taxpayer also operated two businesses that provided Business B services.

The value of the taxpayer's stock remained stagnant between Year 1 and Year 2. In response to this lack of growth, the taxpayer began exploring strategic alternatives to restructure in some way that would acquire and focus resources on its core activities. In Date 1, the taxpayer engaged Consultant to provide advice with respect to its restructuring goals. From Date 1 to Date 2, the taxpayer investigated a variety of restructuring proposals, including (1) maintaining the status quo, (2) leveraged recapitalization or full recapitalization with a spin-off of the lesser business divisions, and (3) divestiture of lesser business divisions. The divestiture proposal contained several subparts, including a targeted stock offering or an IPO with a split-off or spin-off. These three general proposals were presented to the taxpayer's board of directors on Date 3 by Consultant. On Date 4, the taxpayer's board of directors voted to eliminate consideration of (1) maintaining the status quo and (2) leveraged or full recapitalization. Thus, as of Date 4, only the divestiture proposal, including a targeted stock offering or an IPO with a split-off or spin-off remained under consideration by the taxpayer.

On Date 5, the taxpayer's board of directors voted to eliminate consideration of a spin-off or targeted stock offering, leaving only an IPO with a split-off under consideration. On the same day, the board of directors approved a business reorganization to form two companies, the taxpayer and Subsidiary A, consisting of all of taxpayer's lesser business divisions. On Date 6, the taxpayer contributed subsidiaries, assets, and liabilities of its lesser business divisions to Subsidiary A. On Date 7, Subsidiary A filed a Form S-4 registration statement for an initial public offering of stock (IPO) with the Securities and Exchange Commission (SEC). On Date 8, the taxpayer finalized its decision to divest Subsidiary A through an IPO and split-off. An IPO of the common stock of Subsidiary A was completed on Date 9, on Market A. Accordingly, after Date 9, the common stock of Subsidiary A was owned by both the taxpayer and unrelated public shareholders.

The taxpayer then began taking steps to perform the split-off, in which certain shareholders of stock in the taxpayer would exchange their stock in the taxpayer for stock in Subsidiary A. On Date 10, Subsidiary A filed a statement with the SEC concerning the contemplated split-off. However, on Date 11, the taxpayer abandoned the split-off when it became apparent that a split-off of Subsidiary A would not maximize shareholder value. It filed a statement with the SEC withdrawing the split-off registration.

On Date 13, the taxpayer's board of directors approved a spin-off of Subsidiary A. The spin off was completed on Date 14.

The field contends that the taxpayer only intended to enter into one restructuring transaction, and that the various proposals discussed above were mutually exclusive. According, the field maintains, the costs of investigating and pursuing all proposals must be capitalized pursuant to § 263(a) as part of the IPO and spin-off transactions that were actually consummated.

The taxpayer claims that the various restructuring proposals were not mutually exclusive, that the taxpayer could, and ultimately did, enter into a combination of transactions. The taxpayer claims it is entitled to a deduction under § 165 for the costs of any proposals that were abandoned. Alternatively, the taxpayer contends that it is entitled to deduct any investigatory costs incurred when it was investigating whether to enter into a restructuring transaction, and which transaction to choose pursuant to Rev. Rul. 99-23.

LAW AND ANALYSIS:

Section 162 of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See *Commissioner v. Lincoln Savings and Loan Ass'n*, 403 U.S. 345 (1971). However, § 263(a) provides that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the

value of any property or estate. See *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

Section 165 allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. In order to be deductible under this section, a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and sustained during the year. § 1.165-1(b) of the Income Tax Regulations. Further, only a bona fide loss may be deducted. Substance and not mere form governs in determining whether a loss is deductible.

Deductions for abandonment losses are not specified in § 165. However, § 1.165-2(a) of the regulations provides that a loss is deductible under § 165(a) if it is incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein. Accordingly, restructuring costs, otherwise capital pursuant to § 263(a), are deductible losses under § 165(a) when the proposed transaction is abandoned. Rev. Rul. 73-580, 1973-2 C.B. 86.

If a taxpayer investigates and pursues multiple separate transactions, costs properly allocable to any abandoned transactions are deductible even if some transactions are completed. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950), *acq.* 1951-1 C.B. 3. Further, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. *Tobacco Products Export Corp. v. Commissioner*, 18 T.C. 1100, 1104 (1952); *Portland Furniture Manufacturing Co. v. Commissioner*, 30 B.T.A. 878 (1934); *Doernbecher Manufacturing Co. v. Commissioner*, 30 B.T.A. 973 (1934), *acq.* XIII-2 C.B. 6, *aff'd*, 80 F.2d 573 (9th Cir. 1935). These authorities allow a deduction upon the abandonment of a proposed transaction even if subsequent or alternative transactions are pursued.

By contrast, if the proposals are mutually exclusive alternatives, meaning that only one can be completed, then no abandonment loss is proper unless the entire transactions is abandoned. The costs of pursuing any alternatives not consummated must be capitalized as part of the cost of the completed alternative. *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001) (costs of engineering studies to evaluate potential sites to build a distribution facility are capital where the taxpayer intended to choose only one location to build the facility); *Larsen v. Commissioner*, 66 T.C. 478, 483 (1976)(costs of sale include costs of unsuccessful contacts); *Nicolazzi v. Commissioner*, 79 T.C. 109 (1982) (investment was a single transaction rather than 600 separate efforts to obtain one successful lease).

Finally, Rev. Rul. 99-23, 1999-1 C.B. 998, provides that expenditures incurred in order to determine whether to enter a new business and which new business to enter are investigatory costs that are start-up expenditures under § 195.

The facts in this case show that the taxpayer investigated a variety of proposed restructuring transactions, which can be grouped into three main categories: (1) maintenance of the status quo; (2) recapitalization; and (3) various divestiture scenarios for the lesser business divisions. While it is clear that option (1), maintenance of the status quo, is mutually exclusive with pursuing any type of restructuring transaction, we do not believe that taxpayer seriously considered this option or that any substantial portion of the costs at issue were incurred in pursuing an option of doing nothing. We agree with the taxpayer that options (2) and (3) were not mutually exclusive, and that the taxpayer could have entered into some type of recapitalization transaction and also one or more of the divestiture transactions being considered under option (3). Thus, like the taxpayer in *Sibley, Lindsay & Curr Co.*, the taxpayer here is entitled to a deduction under § 165 for costs associated with the recapitalization option in Year 2, because there is clear evidence of abandonment when its board of directors voted to eliminate consideration of this option on Date 4.

Our analysis of the costs associated with option (3), the divestiture of the lesser business divisions, is more complex because we agree, in part, with the taxpayer's position, and, in part, with the field's position. The taxpayer claims it could have entered into a combination of the option (3) subparts, and, indeed it did, by finally consummating both an IPO and a spin-off of Subsidiary A. The taxpayer further claims, that, while impracticable, it was possible to have entered into both a split-off and a spin-off, since, when it began consideration of option (3), it had two separate businesses in its lesser business divisions (one to split-off and one to spin-off). The field contends that all costs associated with option (3) were part of a single, divisive transaction that was consummated as an IPO/spin-off of Subsidiary A.

While we might agree with the taxpayer in theory, the facts in this case demonstrate that the taxpayer only pursued a single divestiture transaction beginning on Date 5, when the board of directors voted to eliminate consideration of a spin-off or a targeted stock offering. On that same date, the board of directors approved a business reorganization which would place all of the assets of the taxpayer's lesser business divisions in Subsidiary A. Two months later, on Date 6, the taxpayer contributed all of the assets and liabilities of its lesser business divisions to Subsidiary A. Thus, beginning with Date 5, the taxpayer pursued only one divestiture option that included an IPO and split-off of Subsidiary A.

The IPO was completed shortly thereafter, and the taxpayer began taking steps to complete the split-off. However, the taxpayer did not complete the split-off after determining that it would not maximize shareholder value. The taxpayer claims it abandoned the split-off transaction and went back to the drawing board and reconsidered all of its divestiture options during Date 12.

We believe a more accurate description of the events is that the taxpayer modified the divestiture transaction from a split-off to a spin-off and completed the spin-off less than

two months later. In general terms, a spin-off and a split-off are very similar transactions. A spin-off is a pro rata distribution by a corporation of the stock of a subsidiary. § 355; see generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 11.01 (7th ed. 2000). A split-off is also a pro rata distribution by a corporation of the stock of a subsidiary, except that the shareholders of the distributing parent corporation surrender part of their stock in the parent in exchange for the stock of the subsidiary. *Id.* Thus, a spin-off results in the existing shareholders continuing to own the stock of both the parent and the subsidiary, while a split-off involves the elimination of some shareholders, who must surrender their stock in the parent in order to receive stock in the subsidiary. However, the end result of each transaction is the same for the distributing corporation—it no longer owns any stock in the subsidiary.

Thus, based on the facts in this case, we believe that the taxpayer pursued a single divestiture transaction beginning on Date 5, which consisted of the transfer of assets and liabilities to Subsidiary A, an IPO, consideration and pursuit of a split-off, and, finally, reconsideration and pursuit of a spin-off. Any costs incurred in consideration or pursuit of an IPO, split-off, and spin-off, incurred beginning in Date 1, must be capitalized as part of the capital restructuring that was eventually accomplished.

Finally, we turn to the taxpayer argument that it is entitled to deduct certain investigatory costs pursuant to Rev. Rul. 99-23, 1999-1 C.B. 998. Revenue Ruling 99-23 holds that costs incurred by a taxpayer in determining whether to acquire an unrelated trade or business, and which trade or business to acquire are investigatory costs that are start-up expenditures pursuant to § 195 (and are eligible for amortization over a 5-year period). The holding of Rev. Rul. 99-23 is limited to acquisitions of new businesses only, since § 195 only applies to start-up expenditures for new businesses. It does not apply to the facts in this case, where the taxpayer only considered divisive, not acquisitive, transactions.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.